

Morgan Stanley Investment Funds

Diversified Alpha Plus Fund

Commentary¹

- What does China's economic slowdown and currency devaluation mean for global growth and inflation? Until recently, the prevailing assumption was a benign decoupling (i.e., developed economies and risky assets will remain unaffected). The past two weeks cast some heavy doubt on this as global equities sold off by 9% in a matter of days, though made up some of the loss later and ended the period down -5.5% (MSCI ACWI in local currency).
- As often happens in upheavals, positioning—not fundamentals—dictates relative performance, and so emerging market equities did marginally better than global equities while Japanese equities, a favourite, were the worst performer (TOPIX down -7.7% in local currency terms). In a similar vein, energy was the best performing sector globally and materials performed in line, whereas financials, a popular sector, were the second worst. Likewise, commodities were up as oil rallied.
- Expectations for the start of U.S. rate hikes were pushed out to early 2016, and more significantly, the pace and magnitude of the rate hiking cycle was re-priced to be more subdued. As a result, gold rallied and the U.S. dollar fell against the euro and the yen as crowded shorts in these currencies were unwound. The dollar continued to rally against emerging currencies, gaining 2.2% (JP Morgan EMCI).
- Despite the beta selloff during the second half of August, the Fund was up 0.1%. Short positions in China-sensitive currencies and Chinese A-shares contributed positively, as well as a short position in U.S. equities and hedged long positions in Eurozone retail banks and other domestically-focused stocks. Detractors included short positions in U.S. 5-year rates and rate-sensitive assets (long U.S. financials vs. Canadian financials, long U.S. life insurance vs. U.S. REITs; both since closed).
- We closed our long position in global equities during the third week in August, and reinitiated a small tactical long in global equities following signs of market capitulation amid extreme oversold conditions. We reduced exposure within our higher U.S. rates theme, decreasing our short position in U.S. 5-year rates and closing our short positions in U.S. credit. We reduced our longs in European vs. U.S. equities and Indian vs. emerging market equities. We initiated a short position in Australian banks relative to developed market banks, as we expect a peaking housing market, heightened scrutiny of foreign investors, and higher capital requirements to pressure margins. We also re-initiated a short position in U.S. refiners relative to U.S. equities, based on our view that capacity additions in Asia and the Middle East will force high cost producers out of the market.
- Global growth estimates have continued to be revised down and high frequency data and surveys are consistent with moderate deterioration. Emerging market economies are at the forefront, with several countries in outright recessions already. We expect China's devaluation to be fundamentally deflationary. Although growth is holding up outside the manufacturing sector in advanced economies, we think the risks from weak growth in China and the emerging markets are not fully appreciated.

Asset Allocation (%) as of 31 August 2015

	Net Exposure ⁴	Gross Exposure ⁵
GLOBAL EQUITY⁶	14.4	105.0
Developed Markets	12.9	97.6
U.S. & Canada	-5.1	21.9
Europe	16.8	64.2
Japan	3.1	9.0
Asia ex-Japan	-1.8	2.5
Emerging Markets	1.5	7.3
GLOBAL FIXED INCOME⁷	-7.0	18.3
Developed Markets	-8.0	8.0
United States	-8.0	8.0
Europe	0.0	0.0
Asia ex-Japan	0.0	0.0
Emerging Markets	1.1	10.2
COMMODITIES	0.0	0.0
TOTAL EXPOSURE (Net of Cash)	7.5	123.2

Net Performance (%) as of 31 August 2015²

Class I Shares	MTD	QTD	YTD	SITC*	Since Inception**
Diversified Alpha Plus Fund	0.1	0.4	-5.9	6.6	4.0

Contribution to Absolute Return (%) as of 31 August 2015³

	MTD	QTD	YTD	SITC*
Equity	-0.8	0.2	-5.6	1.7
Fixed Income	-0.2	-1.1	-2.4	1.5
Commodities	0.0	-0.4	-0.1	0.7
Cash/Currency	1.2	1.9	2.9	3.8

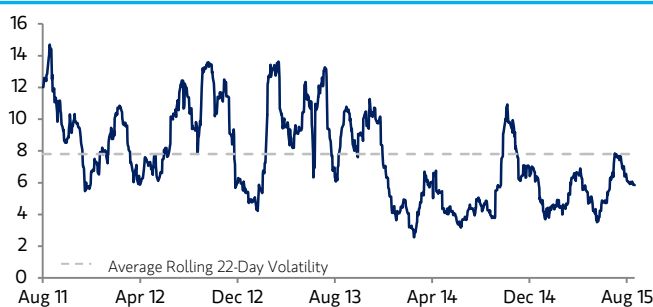
Net Performance as of 31 August 2015 (€)²

Class I shares, performance of €100 invested since change of investment team, 15 August 2011



For net performance since inception, please see graph on page 2

Rolling 22-Day Volatility (%) as of 31 August 2015



Past performance is no guarantee of future results.

Top Thematic Equity Pairs (%) as of 31 August 2015

	Gross Long ⁵	Gross Short ⁵	Net ⁴
Short China-Exposed Autos / Long Global Equities	13.9	-13.9	0.0
Long European Retail Banks / Short European & US Equities	7.5	-7.5	0.0
Short European Staples / Long European Equities	7.3	-7.3	0.0
Long US Consumer Discretionary / Short US Equities	5.4	-5.4	0.0
Short Global Machinery / Long Global Equities	5.3	-5.3	0.0
Long European Domestic Basket / Short US Equities	3.7	-3.7	0.0
Short Global Aerospace / Long Global Equities	3.5	-3.5	0.0
Short Global Auto Components / Long Global Equities	3.2	-3.2	0.0
Short Australian Banks / Long Developed Market Banks	2.1	-2.1	0.0
Long US Airlines / Short US Equities	1.3	-1.3	0.0
TOTAL EXPOSURE	53.1	-53.1	0.0

*SITC (Since Investment Team Change) = annualized performance since change of investment team and policy as of 15 August 2011.

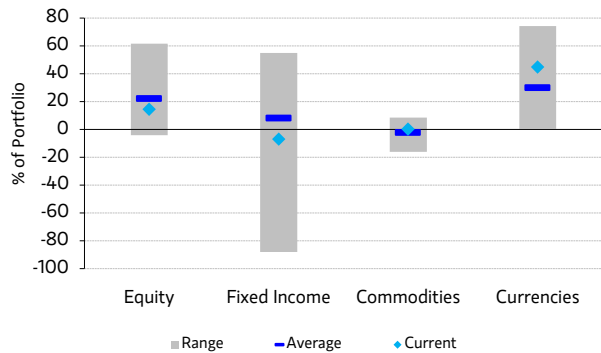
**Inception = annualized performance since 3 June 2008, the launch date of the MS INVF Diversified Alpha Plus VaR 400 (Euro) Fund, managed by a different team with a different investment policy.

Net Performance as of 31 August 2015²

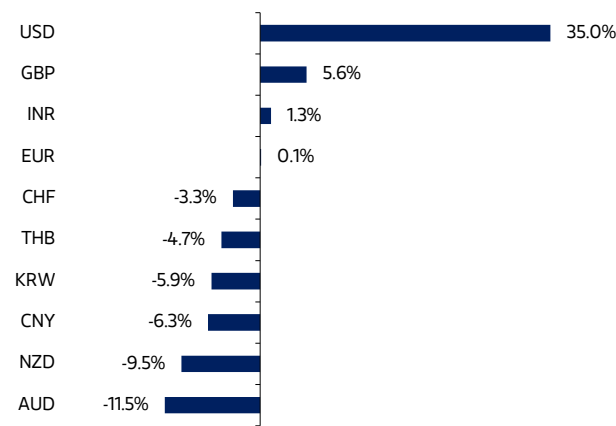
Class I shares, performance of €100 invested since inception, 3 June 2008



Historical Net Exposures as of 31 August 2015^{6,7}



Currency Breakdown as of 31 August 2015⁸



IMPORTANT INFORMATION

This document has been prepared by Morgan Stanley Investment Management Limited as a marketing document to inform Professional Investors and Eligible Counterparts about certain matters concerning the Fund. It has been prepared solely for informational purposes and does not seek to make any recommendation to buy or sell any particular security (including Shares in the Fund) or to adopt any specific investment strategy. Any use of this document by a financial intermediary is restricted to clients for whom the information in this document and an investment in Shares of the Fund has been considered to be suitable by that financial intermediary in view of that client's situation and purpose, subject always to the applicable regulatory standard. If such a client considers an investment in Shares of the Fund, she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

When considering an investment in a particular fund, prospective investors should carefully assess their ability to withstand exposure to the associated risks specified within the Prospectus and applicable Key Investor Information Document.

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Top Fixed Income Positions as of 31 August 2015⁷

	Rating*	Gross Long ⁴	Gross Short ⁴	Net ³
Short U.S. 5-Year Swap (Payer)	A	0.0	-8.0	-8.0
Short Mexican 2-Year Swap (Payer) / Long Mexican 10-Year Swap (Receiver)	A / A	4.6	-4.6	0.0
Long Greek Bonds (Full Strip)	CCC+	1.0	0.0	1.0
TOTAL EXPOSURE**		5.6	-12.6	-7.0

* Includes derivatives. Futures, IG CDX and HY CDX are not rated (NR).

Source: Morgan Stanley Investment Management, FactSet (unless otherwise stated).

Past performance is no guarantee of future results.

- Views expressed herein are the opinions of the GMA team and are subject to change based on market and economic conditions. These views are not necessarily representative of MSIM or the firm as a whole. All performance figures are for the two week period ending 31 August 2015. Source: Bloomberg
- Performance is quoted net of investment management fees and with income reinvested. For cash management purposes the Fund may invest shares in Morgan Stanley liquidity funds.
- Contribution to returns by asset class are meant to be representative of performance and may not sum to actual.
- Net exposure % calculated as $[(MV \text{ of long cash security and derivative positions}) - (\text{absolute value of } MV \text{ in short derivative positions})] / (\text{portfolio } MV)$
- Gross exposure % calculated as $[(MV \text{ of long cash security and derivative positions}) + (\text{absolute value of } MV \text{ in short derivative positions})] / (\text{portfolio } MV)$
- When applicable, equity net and gross exposure is delta-adjusted to account for options trades.
- Fixed income net and gross exposure is duration-adjusted (10-Year U.S. Treasury equivalents), except for CDS and CDX positions, which reflect notional exposures.
- Currency exposure is relative to the Fund's base currency (EUR).

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The sources for all performance and index data are Morningstar and Morgan Stanley Investment Management Limited. Calculations are NAV to NAV.

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